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Beware of the Ides of March: The Demise of HIH Insurance

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Abstract

Despite differences in corporate governance systems in the United States and Australia, the corporate governance failures that led to each country's largest bankruptcy are strikingly similar. WorldCom in the United States and HIH Insurance in Australia were both created by a rapid series of major acquisitions, failed after their last major acquisitions, and attempted to hide their declining performance with aggressive and/or fraudulent accounting practices. In this paper we present a clinical examination of the corporate governance failures that led to the demise of HIH Insurance and show that corporate governance failures are not endemic to the existing corporate governance system in the United States.

Keywords: Corporate governance; International corporate governance; HIH; WorldCom

JEL Classification: F3; G3

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1. Introduction

The collapse of HIH Insurance in March 2001 is the biggest financial collapse in Australia's corporate history. As of March 15, 2001, liquidators estimated that the deficiency for the HIH Group is between $3.6 billion and $5.3 billion.[1] Six months before its collapse, HIH Insurance was Australia's second biggest insurer. As a publicly traded stock, HIH Insurance had only a ten-year history – growing rapidly through a series of acquisitions. The failure of HIH is largely attributable to its last major acquisition, FAI Insurance, and its aggressive accounting practices. Despite the decline of HIH, its CEO received a multimillion dollar severance package when he resigned in the year before its bankruptcy. The fallout since the HIH collapse has been immense because it has triggered a rise in global reinsurance premiums. Domestically, the HIH collapse has impacted housing construction where builders who had previously been covered by HIH had to seek replacement coverage. The collapse also deprived approximately half of Australia's doctors of malpractice insurance and thousands of small businesses lost liability coverage.

WorldCom is the largest bankruptcy in US history. Prior to its collapse in 2002, WorldCom was a leading telecommunications giant and the second largest provider of long distance services in the US. WorldCom's bankruptcy was due in large part to one of its last major acquisitions, MCI Communications, and fraudulent accounting practices. WorldCom was created from a merger between two communications companies in 1993 and grew exponentially through dozens of acquisitions over its nine year history. The CEO of WorldCom also received a multimillion dollar severance package upon his

[1] All values and prices throughout this article are expressed in Australian dollars unless stated otherwise.

resignation in the months before the bankruptcy that led to thousands of layoffs and cast further doubts on the strength of the domestic and international telecommunications industry.

The parallels between the histories and failures of HIH and WorldCom are striking, especially given that the companies were located in countries with differing corporate governance systems. In this paper we analyze the corporate governance failures that aided the collapse of HIH and their similarities to the same failures at WorldCom. Specifically, we examine the similarities and differences between Australian corporate governance mechanisms and those in place in other developed markets and the role these mechanisms played in the failure of HIH. We then highlight the elements of corporate governance which were ineffective in the case of HIH and show how these elements may be used to identify corporate governance weaknesses in other Australian firms and corporations in other developed countries.

The remainder of our study is organized as follows: Section 2 presents a comparison of corporate governance systems in place in major developed markets, Section 3 details the industry and firm-specific factors relevant to the demise of HIH, Section 4 highlights the corporate governance failures that led to the collapse of HIH, and Section 5 concludes.

2. Overview of Developed Countries' Corporate Governance Systems

As LaPorta et al (2000) show, corporate governance systems are the strongest (or most effective) in those countries offering the highest levels of legal protection to stockholders. Among these countries with the highest levels of legal protection, the

United States (US), the United Kingdom (UK), Germany, and Japan have been compared and contrasted for their differences in corporate governance systems. Of interest in comparative studies is why these developed countries have such variance in their corporate governance systems and the advantages and disadvantages to each system.

While different in some aspects, corporate governance systems in the US and UK (and Canada as well) are more similar than different and researchers often classify them as the same when compared to systems in place in Germany and Japan [see Kaplan (1994a, 1994b)].[2] The defining characteristics of this "Anglo-American" corporate governance system is its external mechanisms and open market orientation. These two characteristics are intertwined to form an active external market for corporate control and managerial labor. As Manne (1965) points out, poor corporate governance will lead to a depressed stock price and a takeover opportunity whereby managers of the acquired firm are replaced. Fama (1980) furthers this concept of external market discipline with his theory of "ex post settling up". Under this theory, managers who have been terminated because of their firms' poor performance face a harsh labor market and generally do not achieve the same level of status or compensation as before the termination. These external market mechanisms are designed to encourage managers to act in shareholders' best interests. Corporate governance changes may occur rapidly in the Anglo-American model, causing Kaplan (1994a) to term this model a "short term" corporate governance system.

Other characteristics common in the US/UK model include a single board of directors with a mix of management (inside) and non-management (outside) members.

[2] The US and UK are becoming closer given the similar recommendations of the Cadbury and Hampel Committees in the UK and the revised 2002 listing requirements in the US.

The chief executive officer (CEO) almost always serves on the board – often as chairman.[3] In the UK, and increasingly in the US, the boards' audit and compensation committees are comprised of outside directors. CEOs are generally shareholders in their firms, but the levels of holdings vary greatly.

In contrast, the German and Japanese corporate governance systems are better described as long-term relationship models. External control mechanisms are minimal, but shareholdings are more concentrated – often held by financial institutions with a major presence on firms' boards. In Germany the board structure is bifurcated into a supervisory and management board. This is somewhat similar to the Anglo board/management structure but with notable exceptions. First, the two boards are mutually exclusive. Thus, the supervisory board, which oversees the management board, is a board of strictly outside directors. Second, the supervisory board appoints and charges the management board. This differs from the Anglo model where the CEO generally has some, or even total, control over the selection of the board of directors. Third, CEOs in Germany tend to have less absolute power over their corporations than in the US/UK model.[4]

The CEO and/or chairman of the board also has less power in Japanese corporate governance systems where decision by consensus is the norm. Board structure and function is different from both the Anglo and German models. Dominated by inside directors, the boards of Japanese companies are largely made up of current and former employees who tend to have negligible ownership stakes in the firm. As in the German system, shareholdings are concentrated and institutional ownership is higher than in the

[3] Although the dual CEO/chairman role is becoming less frequent in both countries.
[4] For further comparisons, see John and Senbet (1998).

US/UK. However, institutional shareholders tend to be less proactive in the Japanese system.[5]

Australia is a developed country with a corporate governance system combining elements of both the external and internal control mechanisms described above. The general structure of the Australian corporate governance system is a hybrid of the Anglo-American, German, and Japanese models. As pointed out by Suchard et al (2001), Australian corporate governance mixes the Anglo board structure with the internal "relationship" corporate governance mechanisms seen in Germany and Japan. Australian firms have a single board of directors comprised of inside and outside members. Following the 1991 Bosch Report, directors are classified into three categories: executives, independent non-executives, and non-independent non-executives. The dichotomy of classification of non-executives relies on a comprehensive list of current and past relationships between the director and firm. Directors are deemed independent only if they have no current or prior relationship with the firm as an employee, professional advisor, or having no other contractual relationship to the company.

However, Australian firms tend to have less diffuse shareholdings than in the US and UK. Australian markets also differ in that hostile takeovers are rare and not viewed as a source of external discipline as in the US/UK model. Rather, the few blockholders with the large concentrations of shares are expected to serve as monitors of the firm much as in the case in Germany and Japan. This mixture of a board structure designed to be monitored by open and external governance mechanisms with closed and internal monitoring mechanisms has led some to question the effectiveness of the Australian

[5] For further comparisons, see Kang and Shivdasani (1995).

corporate governance system.[6] The HIH collapse highlights some of the shortcomings of the Australian corporate governance system.

3. Relevant Industry and Firm Information

3.1 The Australian Insurance Industry

The Australian insurance industry represents 2% of the international market in general insurance and is ranked the 11th largest market in the world. For the year ending 2000 there were 161 Australian Prudential Regulation Authority (APRA) licensed private sector insurers and reinsurers writing insurance inside Australia. Panel A of Table 1 indicates how these private sector insurers are classified.

INSERT TABLE 1 HERE

Table 1 also provides details regarding the insurance industry as a whole. 1999 was not a particularly good year for the insurance industry due to a series of natural disasters. However, 2000 proved to be a much better year. Despite the improving economic environment, insurer New Cap Re failed while others struggled significantly (e.g. Reinsurance Australia Corporation and GIO Insurance). In the following year, HIH Insurance, Australia's second largest insurer, went into provisional liquidation.

The US telecommunications industry, while not so affected by events of nature, witnessed a severe decline beginning in the late 1990s. Sources of financing so readily available in earlier years to WorldCom, industry leader AT&T, and even upstarts such as Global Crossing for financing their acquisition programs and/or capital investments dried up as the capital markets realized that the long distance business was in decline, prior acquisitions had not lived up to promised potential, and the quality of certain telecom

[6] Reference FT article here.

assets (especially fiber optics) were coming under increasing scrutiny. Global Crossing preceded WorldCom to bankruptcy by a matter of months in 2002.

3.2 The History of HIH Insurance

HIH Insurance began in 1968 when Ray Williams and Michael Payne established MW Payne Underwriting Agency Pty. Ltd in Australia. After being acquired by a British insurer in 1971, the firm that became HIH was spun-off as a publicly-traded firm on the Australian Stock Exchange in 1992. Through a decade of multiple acquisitions, mergers, and name changes, HIH diversified into many insurance sectors with operations in multiple countries. Table 2 provides a detailed history.

INSERT TABLE 2 HERE

By 2001, the HIH group consisted of 217 subsidiaries with operations in a number of countries. Within the HIH group the three largest licensed insurance companies were HIH Casualty and General Insurance Limited, FAI General Insurance Company Limited and CIC Insurance Limited. HIH Insurance Limited was the listed holding company. Prior to its collapse, HIH Insurance's principal activities in Australia and internationally were general insurance underwriting, the operation of insurance underwriting agencies, investment funds management, financial services and property. The company also managed workers' compensation schemes in New South Wales, Victoria and South Australia.

Evidence of HIH's aggressive approach to accounting surfaced as early as 1992 in a due diligence report by Ernst and Young performed for CIC Holdings while in merger talks with CE Heath International (an earlier version of HIH). Heath was found to have understated liabilities by $18 million and under-reserved by $41 million (much of this sum constitutes a "prudential margin", a very common prudent insurance company practice of reserving approximately 20% more capital beyond what is necessary to cover expected liabilities).[7]

Ray Williams, CEO of Heath, disagreed with the need for a prudential margin. A second report by an independent expert was drafted and recommended that the merger still take place. The independent expert was Alan Davies of the public accounting firm Arthur Andersen. Davies later became HIH's lead auditor in 1996 when the former auditor, Dominic Fodera, became HIH's finance director.[8]

Similarly, WorldCom had been accused by former employees of accounting improprieties for overbooking revenue and not writing off bad accounts receivable in a lawsuit that was dismissed a couple of years prior to the bankruptcy. The controller and CFO were later indicted for accounting fraud for understating expenses by more than US$ 3 billion. Arthur Andersen also served as the auditor of WorldCom.

Despite the aggressive accounting and the potential agency issues with auditors, the beginning of the end of HIH focuses on a particular acquisition in 1998. HIH initiated a formal takeover of domestic insurer FAI Insurance Ltd. in September 1998, completing the takeover in January 1999. According to its annual report, HIH's strategy was to secure a major market share position in the Australian general insurance industry and to diversify its distribution channels. A major stakeholder in FAI, the Adler family, sold their 45 million shares, or 14.2% stake, in FAI to HIH for $34 million. HIH Insurance announced it had purchased the Adler family stake and would make a bid for

[7] See Sykes (2002b).
[8] See Main (2002a) for more detail on these relationships.

the remaining shares of the company. The terms of the offer were one HIH share and $2.25 cash for every six FAI shares. At the time, this would value FAI at approximately $300 million. At the time of the proposed acquisition, HIH announced that it intended to retain FAI's personal lines insurance business as a discrete unit within HIH and would retain the FAI brand name in its retail operations. The reinsurance program would also be consolidated, both companies' corporate insurance portfolios would be merged, and the IT systems would be integrated. After the FAI takeover, the HIH group accounted for more than 10 percent of the general insurance business in Australia. Rodney Adler, CEO of FAI, was then named a director at HIH.

In early 1999, HIH announced that it had suffered a 39% profit plunge in the year through December. Declining premium rates, record low interest rates and the second worst year on record for natural disasters were given as reasons for the profit plunge. Such disasters included storm and flood damage along Australia's East Coast, Hurricanes' George and Mitch, Canadian ice storms, and a large scale power outage in New Zealand. As a result of these disasters, claims expenses increased sharply and the core underwriting resulted in a loss of $73.4 million for 1998 with catastrophe losses totaling $36 million. CEO Ray Williams claimed that 90% of the 2.5% increase in the group's combined ratio (a measure of claims and expenses to net earned premium) was attributable to the catastrophe claims. The group's combined ratio grew from 102.7% to 105.2%. FAI Insurance recorded an unaudited loss of $50-$60 million for the six months to December and suffered a $22 million loss on investments for the first quarter. Despite this, by the end of March 1999, HIH's earnings potential had received an upward rating by stock analysts.

However, the credit quality of HIH had already been downgraded from A to A^- by Standard and Poors in January 1999 due to concerns over the acquisition of FAI. HIH attempted to allay the fears of the rating agencies by issuing subordinated debt with quasi-equity characteristics because it hoped to neutralize rating agencies' concerns about its indebtedness, while also addressing shareholders' concerns of dilution by a straight equity issue.

Yet, losses continued to mount during the year and the stock price continued to drop. By June, shares had slipped below the $2 mark. Then in August, HIH posted a $58.8 million loss for the first six months of 1999. Two losses stood out at this time - a $50.1 million loss on the sale of FAI's former asset, Oceanic Coal, and a $50 million abnormal loss related to the introduction of the Goods and Services Tax (GST) that would take place in Australia on July 1, 2000. Despite these losses, HIH still intended to pay dividends and, according to media reports, was aiming at a 70% to 80% payout ratio. Analysts had determined that HIH would have to generate at least $80 million in retained earnings in order to make this dividend payment. During this period, HIH changed its financial year-end from December 31 to June 30, justifying the decision because of the need to standardize internal reporting periods following the takeover of FAI Insurance so that investors could make more meaningful comparisons with competitors.

At the start of 2000, HIH benefited by offloading part of its stake in the telephone company One.Tel for about $35 million (One.Tel would also later collapse in 2001). In January, the company also sold part of its business in Argentina and ceased to be a substantial shareholder in a number of companies. Also in January, HIH decided to sue former clients in order to recover an alleged overpayment of funds.

Reported profits for the last two quarters of 1999 exceeded expectations by about $10 million. HIH pointed to an improved underwriting result, $25 million in cost savings from the integration of FAI Insurance, and disposal of that acquisition's last major non-core asset as reasons for the improvement. However, reinsurance, which represented 5% of HIH's business, contributed a $16.6 million loss as a result of exposure to the European windstorms in December. Standard and Poors confirmed HIH's credit rating of A^- in February.

As the year progressed, so did the negative news events for HIH. At the end of May, HIH denied claims that it had withheld from its shareholders relevant information about two takeover offers and a potentially expensive indemnity case. By the middle of June 2000, HIH shares were trading at half the price they had been twelve months earlier. HIH management attributed the drop in share price as an irrational response to negative publicity aimed at HIH Insurance in the media. At the end of June, analysts expressed concerns regarding HIH's ability to pay its claims. In July HIH suffered more profit downgrades by analysts based on concerns of lower investment income and an expectation that predicted premium rate increases would not occur.

Several news events continued the decline of HIH's stock price. On September 11, HIH shares were suspended from trading as the company delayed its profit announcement. Three days later, two news events caused a further 20% slide in stock price. First, reported financial results for the first two quarters of 2000 were far worse than expected by analysts. Second, HIH announced a deal to sell its personal lines business to German insurer Allianz. The terms were that 51% would be owned by Allianz and 49% by HIH. HIH would receive $200 million at the time of the deal and proportional earnings for up to five years. After the five years Allianz would have an option to buy HIH's interest, while HIH could sell its 49 percent interest at any time during the following five years for $125 million.

The negative market reaction stemmed from investors' belief that HIH was selling its best assets – its personal lines business. Although this action would return HIH to its original focus of corporate insurance, analysts were concerned about the long-term viability of the company and grew suspicious of its accounting practices. HIH shares slumped another 30% the day after these announcements.

In order to support the stock during this downfall, CEO Williams bought 1.05 million shares and another board member bought 227,000 shares. At about the same time, director and former FAI CEO Rodney Adler began selling shares.

The stock's decline was not reversed by Williams' stock purchases or his strategic decisions and so he tendered his resignation on October 12. The company concurrently announced other restructuring moves, including that Australian executives would no longer sit on the board of HIH, reducing the size of its board from 11 to 7. The reason cited was that such a change was aimed at increasing the independence of the board. The capital markets greeted this news favorably and Adler continued selling shares soon thereafter.

Some media outlets began speculating that HIH's crisis was linked to the FAI takeover from two years prior. Apparently, no formal review of FAI's books occurred before HIH launched its $300 million takeover. Instead, the decision to buy FAI was based on a review of publicly available information such as annual reports and company results without a due diligence effort. After the takeover of FAI, HIH shut down several of FAI's insurance books. However, in the two-year period subsequent to the takeover, claims from those books had swollen to approximately $400 million, indicating that FAI was effectively insolvent when HIH bought it.

In November Standard and Poors dropped the credit rating of HIH from A^- to BBB^+ - attributing the downgrade to a lower quality balance sheet that had emerged as a result of the deterioration in the FAI book of business and poor underwriting performance in HIH's UK and US operations. In response to the downgrade, HIH constructed a revival plan that included abandoning its loss-making U.S. workers' compensation business and placing its Asian operation (estimated to be worth $80-$90 million) up for sale. Once the restructuring was completed, HIH consisted of: the Australian corporate insurance line, a minority stake in the Allianz joint venture and business in New Zealand and London.

A new CEO, Randolph Wein (former head of Asian Operations), was announced on December 15, 2000. At the shareholders meeting, investors jeered the former CEO when it was announced he would receive an estimated $5 million payout. In February 2001, the new CEO announced a flatter management structure for HIH Insurance. Rodney Adler, who had sold the last of his shareholdings in late December 2000, resigned at the end of February, 2001. The Australian Securities and Investment Commission (ASIC) announced an investigation of his share trading shortly afterwards.

WorldCom Chairman and CEO Bernard Ebbers also negotiated a multimillion dollar severance package when he was forced to resign in the months preceding the bankruptcy. WorldCom also later announced that the board had previously approved a multimillion dollar loan from the firm to Ebbers. While not illegal at the time, approval of loans of this magnitude to a company executive called into question the fiduciary responsibility of the board.

Shares in HIH were suspended on February 22, 2001 and again on February 27, 2001. Standard and Poors lowered HIH's credit rating from BBB^{+} to BBB^{-} and retained a credit watch on the company. The Australian Securities and Investment Commission (ASIC) also launched an investigation into HIH's market disclosure. Amongst speculation that HIH's half-year loss to December would be between \$100 and \$500 million, the Australian Stock Exchange (ASX) commenced delisting talks with HIH at the start of March 2001.

On March 7, HIH announced that it had sold a majority part of its corporate insurance operation to insurer QBE, who would effectively pay \$36 million for the right to 60% of HIH's \$600 million in premiums. What QBE would not take on was HIH's liabilities. Allianz bought the remainder of HIH's retail venture for \$125 million and NRMA bought HIH's worker's compensation business for \$130 million. On March 12, 2001 the Australian Prudential Regulation Authority (APRA) announced that it had already provided notice to HIH as to why it should be investigated. Amongst estimates of a half-year loss of \$800 million, HIH put itself into provisional liquidation on March 15, 2001 and representatives from KPMG were appointed liquidators to the company and 17 of its controlled entities. A temporary form of administration, provisional liquidation gives a company time for the provisional liquidators to review a corporation's operations and assess its financial position.

Figure 1 displays the share price for the period 1992-2001. Data for the Australian Insurance sector index and the Australian All Ordinaries Index are also contained in Figure 1.

INSERT FIGURE 1 HERE

4. Corporate Governance Issues

Previous research links general corporate and insurance failures to unsupervised delegation of authority, rapid expansion, underpricing, reserve problems, false reporting, reckless management, rapid expansion, and incompetence. In this section we examine the legal and organizational framework, including the principles and processes, by which HIH was governed. In addition, we also focus on the accountability and relationships of key participants in the direction and control of the company - the board of directors and management. First of all, we will describe the legal and regulatory framework in which an Australian insurance firm, like HIH, operates.

4.1 The Regulatory Environment of the Australian Insurance Industry

The Australian insurance industry is regulated by Federal, State and Territory legislation. The Federal regulatory structure is made up of three key authorities: the Treasury, the Australian Prudential Regulation Authority (APRA) and the Australian Securities and Investment Commission (ASIC). The Treasury sets regulatory policy including drafting legislation. Prudential regulation of the industry is undertaken by APRA and market conduct is regulated by ASIC.

APRA first became aware of HIH's aggressive accounting in 2000 when a former HIH finance executive, Jeff Simpson, provided a report that essentially stated that HIH was already financially insolvent. Simpson noted that the APRA appeared understaffed and under-skilled (Main, 2002b). Inquiries after the HIH collapse noted that Arthur Andersen approved HIH's financial statements knowing that large losses were not being reported (Sykes, 2002a). The situation is similar to that in the US where several corporate failures of firms audited by Arthur Andersen could not be pre-empted by the Securities and Exchange Commission (SEC) because of their claimed understaffing.

ASIC's responsibility in regard to HIH deals primarily with the public disclosure of financial reports, corporate executive conduct, and the conduct of market participants. Although ASIC has not to date aggressively pursued the potentially fraudulent financial reporting of HIH and FAI, Rodney Adler has faced prosecution and investigation in regards to corporate misconduct and insider trading.

Before it can launch a formal investigation into a business, APRA must give and insurer 14 days notice. APRA allegedly gave HIH notice on March 1, 2001 that it was preparing an investigation – a decision triggered by HIH's failure to file its December report. On March 14, HIH went to the Supreme Court and placed itself into provisional liquidation without prior notice to APRA. On the next day the APRA investigation began.

4.2 Board Structure and Compensation

A cornerstone of corporate governance is an understanding of the powers, accountability and relationships of those who participate in the direction and control of a company. The participants include the board of directors and management. As of September 2001, Australian Stock Exchange (ASX) Listing Rule 4.10.3 requires that a listed company's annual report contain a statement of the main corporate governance practices it has in place.

In addition to executive directors, an Australian board of directors may include non-executive directors. The main role of the executive directors is to carry out day-to-day management of the company's business. Consequently, executive directors are usually full-time employees of a company and are usually its senior management. Executive directors also have directorial duties of the company and may also have additional duties as part of their employment contract. On the other hand, non-executive directors are not employed by the company and are engaged on a part-time basis. Rather than focused or specialized in any particular area of a company's operations, the non-executive director is intended to have a broad and independent view of the company's operations.

Farrar (1999) examined the corporate governance practices of the top 100 listed Australian companies. He found that all the companies surveyed stated whether directors were executive or non-executive. Farrar also found that the average board size was 9.6 members, comprising 2.2 executive directors and 7.4 non-executive directors. The 2000 Korn/Ferry Report states that Australian boards were made up of an average of five non-executive and two executive directors. This board structure is similar to that found in Anglo-American firms.[9]

"*Corporate Practices and Guidelines*" claims that independence is more likely to be assured if the director is not a substantial shareholder of the company, is not retained as a professional adviser by the company, is not a significant supplier to or customer of the company, has not been employed by the company within the last few years, and has no significant contractual relationship with the company otherwise than as a director. Of concern in the case of HIH Insurance was that it was led by its founders and non-executive board member, Rodney Adler, who was the son of the founder of FAI Insurance, the company that has been referenced as a determining factor in the collapse of the HIH Group.

Lawrence and Stapledon (1999) explain that using independent directors is one element of a broader tapestry of monitoring devices and rules which serve to reduce agency costs in a corporation. Lawrence and Stapledon use Australian data and find that independent directors do not appear to have added value in the period 1985-1995.

Stapledon and Lawrence (1996) investigate the issue of independent directors in an Australian context. The disadvantages of independent directors include: some independent directors are still too closely allied to management, their position is weakened where the chairperson is not an independent director, they lack detailed knowledge of the company's business, they have limited time to spend on the directorship and they are sufficiently linked with shareholders.

{Are these citations and interpretations correct? Some of the verbage appears contradictory}

According to the Korn/Ferry Report, the average remuneration for non-executive directors in Australian listed companies was $A52,760 as of 2000. As can be seen in Table 3, the direct compensation of the directors of HIH was well above this average. Additionally, several directors held substantial equity stakes in the firm. Of course,

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[9] See Yermack ().

linking director remuneration to share price presents a number of inherent dangers. For one, it can lead to a disproportionate focus on short-term performance and pre-occupation with supporting the share price.

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4.3 Accounting Issues

The Australian Accounting Standards Board (AASB) sets the accounting standards for Australian companies. According to AASB standards, companies must provide in their annual report a profit and loss statement, a balance sheet and a statement of cash flows. Under AASB standards, the financial statements must indicate a “true and fair view” of the financial position and performance of the company. An Australian company also has various semiannual reporting obligations. The law after July 1, 1998 also requires that a company’s annual financial report (or its concise version) must be audited and lodged with the Australian Securities and Investment Commission within three months of the end of the financial year.

The case of HIH also refocused attention on the controversial issue of the independence of the auditors from their clients. The board of HIH had three former partners of Arthur Andersen, HIH’s auditor. In October 2000, the auditor signed off on HIH’s financial statements, indicating the company had assets of $8.32 billion against liabilities of $7.38 billion, giving it net assets of approximately $940 million. Andersen received $1.7million for its work as auditor to the HIH group for the 12 months ended June 30, 2000.

In retrospect, certain items on HIH Insurance Group's balance sheet requires further scrutiny. Shareholders' funds in the 2000 annual report were estimated to be $939 million, but the supporting were of suspect value. In the 2000 annual report HIH's assets included intangibles of approximately $500 million, the bulk of which represented goodwill for FAI. On the liabilities side, there was approximately $500 million in borrowings. The substantial amount of debt carried by HIH is troubling. An insurance company's investment portfolio holds the premiums the company collects from its policy holders and generates investment income as an internal source of capital. Thus, there is little reason for an insurance company to seek external debt except for one-time purposes such as a takeover. Compared with the previous year, HIH's debt had risen by $170 million in 1999-2000 (a nearly 50% increase). According to its cash flow statements, HIH's premium income dropped 15%, or $486 million.

The HIH offer for FAI Insurance was at a 43% premium to FAI's market capitalization. Of the $300 million HIH paid for FAI, $157 million was for net assets and $143 came in the form of goodwill. By June 30, 2000, HIH's goodwill had increased to $555.9 million and analysts estimated that $405.3 million of that total was related to FAI assets. Thus, within 18 months of FAI takeover, the net assets acquired from FAI were valued at a loss of over $100 million. This prompted the managers of HIH to consider legal action to determine if the financial position of FAI had been intentionally overstated at the time of the acquisition. Interestingly, FAI also used had Andersen as its auditor.

FAI was not the sole contributing factor to HIH's growing problems. On the reinsurance side, according to press reports, by June 2000, HIH had run out of reinsurance cover and presumably did not have a sufficient prudential margin nor sufficient assets to cover its claims. HIH's expansion into the competitive Lloyd's market (with losses of approximately $150 million) and US workers' compensation sector are other possible reasons. One accounting issue that received some scrutiny from analysts was the decision by HIH to treat its increase in reserving as a goodwill item. While an acceptable accounting treatment, such a practice would be reflected in a company's profit and loss statement under more conservative accounting practices.

The main concern with insurance companies' published accounts is with their reserving, or the amount that the insurer shows as its liability for outstanding claims. Three of the most important factors include the actuary's estimate of the dollar value of future claims (based on claims experience and probability), the inflation rate by which that estimate may be increased, and the interest rate at which the estimate should be discounted. Clearly, this calculation is open to some educated guesswork and subjectivity. Once the insurance company has calculated its outstanding claims in the manner described it will normally add a prudential margin of 10% to 25%. HIH did not add this prudential margin to their reserve balance. This practice made HIH look stronger than its industry peers allowing a stronger credit rating until the string of catastrophic events depleted its shallow reserves.

Another subjective accounting practice potentially abused by the managers of HIH is how the actuarial assumptions of outstanding claims are determined. A small change in interest rates or assumptions about claims frequency can make large differences to the present value of outstanding claims, in turn changing the net assets of the insurance company quite dramatically. The rate of interest is important particularly when it is compounded over long periods. For example, the lower the inflation rate and the higher the discount rate used, the lower the dollar value will be of the outstanding claims. In the case of HIH Insurance, the inflation rate estimate for 2000 was 3.8%, down from the 1999 estimate of 5% (see Table 4). The discount rate HIH used in 2000 was 6.4% versus 6.1% for 1999. This 1.5% increase in the gap could have reduced claims reserves by as much as $100 million. Revising the two adjustments to the inflation rate and discount rate alone would have wiped out $360 million of HIH's shareholders' funds. Thus, these minor movements in rates could have artificially inflated the capital base by more than one third.

INSERT TABLE 4 HERE

Again, the parallel situation existed at WorldCom. The aforementioned aggressive turned fraudulent accounting practices at WorldCom allowed them to maintain their investment grade debt rating and issue a US$__+ million bond issue in the year before the bankruptcy. An internal auditor found the accounting fraud after the resignation of Ebbers and reported it to the board who eventually investigated the fraud. Arthur Andersen never uncovered the fraud, but did receive US$___ million in consulting fees from WorldCom in the year before the bankruptcy. In both cases, debt was increased as a source of capital on the basis of inflated accounting numbers and lofty bond ratings.

5 Conclusion

The bankruptcies of HIH and WorldCom demonstrate that certain corporate governance failures are common across different corporate governance systems. Both were the largest bankruptcies in their respective countries and the factors that led to both failures were relatively the same – a rapid acquisition program, one large problematic acquisition, aggressive and/or fraudulent accounting, increased leverage obtained on the basis of inflated accounting numbers, and a lack of independence with respect to the board of directors and auditors.

In the wake of these bankruptcies, the regulatory agencies in both countries are taking a more proactive role in overseeing corporate governance. The Australian government established a rescue package to compensate resident individuals and small businesses. In addition, the Australian government announced a Royal Commission to report on the HIH failure. At the time of this writing, the HIH Royal Commission was still in progress. However, in the meantime civil proceedings had been brought against three directors (Rodney Adler, Ray Williams, and Dominic Fodera). All were found to have breached their duties as directors under the Corporations Act. Adler and Williams were jointly held liable to pay compensation of more than $7 million and were banned from being involved in company management for terms of 20 years and 10 years respectively.

In the United States, criminal charges have been brought against WorldCom controller ____ and CFO Scott Sullivan. At the time of this writing, ___pled guilty to accounting fraud. This bankruptcy, along with other high profile corporate governance failures that led to bankruptcies at Enron, Global Crossing, and Adelphia, sparked a movement towards tighter monitoring of the corporate governance mechanisms in place in the US. Namely, the Sarbanes-Oxley bill requires the independence of auditors by disallowing auditing firms from offering consulting services to their clients. Also, the

New York Stock Exchange and Securities and Exchange Commission have enacted more stringent corporate governance practices.

This case illustrates how corporate failures are inextricably linked to corporate governance failures, regardless of the corporate governance system in place. We show that the major factors to the bankruptcies of HIH and WorldCom were corporate governance failures – too rapid of an acquisition program, poor integration of a takeover target, accounting malfeasance, and a lack of board and auditor independence. While market conditions did play a role in the demise of these companies, many of their competitors remain. Thus, these bankruptcies were less a result of economic Darwinism than preventable breaches of proper corporate governance. As these abuses span different corporate governance systems, they are not the result of the system at hand and may be addressed internationally. As the same corporate governance abuses occur repetitively, the confidence of all investors is undermined and international economic interests are at stake, not just individual companies and their shareholders.

Table 1
Panel A
Classification of Licensed Private Sector Insurers and Reinsurers inside Australia
Year: 2000

Type of Insurer	Number of Insurers
Direct Underwriters	104
Mortgage Insurers	17
Captive Insurers	6
Reinsurers	30
s.37 exempt Insurers	4
Total	161

Panel B

Summary Statistics for the Australian Insurance Industry 1999-2000

(in Millions $Aust)

	Dec-99	Dec-00
Premium Revenue	$18,379,291	$19,035,745
Less: outwards reinsurance expense	3,935,729	4,757,772
Net premium revenue	14,443,562	14,277,973
Claims Expense	20,583,455	17,725,196
Less: reinsurance and other recoveries revenue	7,144,384	5,715,936
Net Claims Expense	13,439,071	12,009,260
Underwriting expenses	3,933,455	3,763,382
Underwriting result	-2,928,964	-1,494,669
Plus investment revenue rising from:		
Interest	1,384,330	1,491,894
Dividends	285,193	449,321
Rent	76,155	52,130
Plus other revenue	123,977	132,431
Plus changes in net market value on investments	482,738	1,570,750
Less general and administration expenses	811,678	669,643
Profit/loss from general insurance	-1,388,249	1,532,214
Plus: profit/loss from business other than general insurance	30,039	87,439
Operating profit/loss before extraordinary items and income tax	-1,358,210	1,619,653
Less: income tax expense attributable to operating profit	-121,453	100,409
Operating profit/loss after income tax	-1,236,757	1,519,244
Plus: profit/loss on extraordinary items net of tax	-21,535	-34,064
Operating profit/loss after extraordinary items and income tax	-1,258,292	1,485,180

Source: Australian Prudential Regulation Authority. Data are in Australian dollars.

Table 2
Chronology of Key Events at HIH Insurance

1968	Ray Williams and Michael Payne establish M W Payne Underwriting Agency Pty Ltd.
1971	M W Payne Underwriting Agency acquired by CE Heath plc of the UK
1980	Ray Williams appointed to board of CE Heath plc
1987	CE Heath plc establishes workers compensation underwriting operation in California USA
1989	Business of CE Heath plc transferred to CE Heath International Holdings Ltd (CE Heath), with 90% shareholding retained by CE Heath plc
1992	CE Heath lists on the Australian Stock Exchange. This results in 45% of the issued capital owned by the public, 44% by CE Heath plc and 11% by CE Heath directors and staff.
1993	CE Heath commences operations in the UK.
1994	CE Heath sells its workers compensation underwriting operation in California, USA
1995	CE Heath acquires CIC Insurance Group ("CIC"). CIC Holdings becomes Winterthur Holdings Australia Ltd, a wholly owned subsidiary of Winterthur Swiss Insurance Company ("Winterthur Swiss").
1996	CE Heath changes its name to HIH Winterthur International Holdings Limited ("HIH Winterthur"). HIH acquires Utilities Insurance.
1997	HIH Winterthur repurchases the workers compensation subsidiary in California, Heath Cal, subsequently named HIH America Compensation and Liability Insurance Company ("HIH America").
1997	HIH Winterthur acquires Colonial Ltd General Insurance operations in Australia and New Zealand. HIH becomes Australia's largest writer of bankassurance.
January 1998	HIH Winterthur acquires Solart in Argentina
February 1998	HIH Winterthur establishes representative office in Beijing, China. HIH Winterthur acquires minority interest (24.46% stake) in Nam Seng Insurance plc of Thailand
April 1998	HIH Winterthur acquires the Cotesworth Group Ltd in London, UK, a managing agency of four Lloyds syndicates
June 1998	HIH America acquires Great States Insurance Co of Arizona, USA
July 1998	Winterthur Swiss announces it is selling its 51% shareholding in HIH Winterthur to the public. HIH shares trade around $2.85.
August 1998	Sale of shareholding complete

September 1998	HIH Winterthur announces proposed takeover of FAI Insurance Ltd. Adler family unloads 14.3% stake. HIH announces it had purchased the Adler family stake. Shares trade around $2.50.
September 1998	HIH blacklists stockbroking analysts who disputed the assessment of the company.
October 1998	HIH Winterthur becomes HIH Insurance Ltd
January 1999	S&P downgrades HIH's corporate credit rating from A to A- FAI takeover complete.
February 3, 1999	HIH's converting notes make a strong debut on ASX
March 3, 1999	HIH enters formal negotiations for the sale of its 45% stake in FAI Life. HIH posts a 39 per-cent fall in 1998 net profit.
March 4, 1999	HIH announces it has suffered a 39% profit plunge
March 26, 1999	HIH's earnings potential receives an upward rating by stockbroking analysts
April 1999	As result of Sydney hailstorm, expected total loss of $27 million. The group also estimates its net loss due to reinsurance to be no more than $10 million
April 21, 1999	HIH steps up sale of non-core asset, Oceanic Coal. Shares fall to $1.99
June 30, 1999	New financial year-end used. Changed from Dec. 31 to June 30
August 26, 1999	HIH posts $58.8 million loss in the six months to June
September 15, 1999	HIH continues to pay dividends despite heavy losses. However, dividends had been slashed in half.
February 1, 2000	HIH ceases to be a substantial shareholder in OAMPS.
February 3, 2000	A- rating confirmed by Standard & Poor's
March 2000	HIH returns to profitability for the first half of 1999/2000.
March 2, 2000	HIH announces plans to develop the St. Moritz Hotel in NY with Millenium Partners.
March 3, 2000	HIH sells about half of it St. Moritz investment.
March 28, 2000	HIH takes a 10% stake in Safe Trade, an internet insurer.
March 29, 2000	HIH decreases its interest in Armourglass (from 10.55% to 8.91%).
March 31, 2000	HIH decreases holding in Acclaim Uranium NL (12.10% to 10.8%).
April 5, 2000	HIH decreases it interest in Armourglass (8.91% to 7.64%)
May 8, 2000	HIH decreases it interest in Acclaim Uranium (10.8% to 9.60%)
June 15, 2000	Share price falls to new low of $0.96.

June 20, 2000	Announcement that Rodney Adler, an executive non-director had topped up his holding in the company to 1.86%
July 1, 2000	Goods and Services Tax (GST) introduced in Australia.
September 2000	Joint venture with Allianz announced. HIH sells part of its domestic personal lines to Allianz for $500 million.
September 12, 2000	George Sturesteps and Michael Payne resign as directors of HIH.
October 12, 2000	Dominic Fodera resigns as director of HIH. Also in October, the US business is placed in run-off. Ray Williams, CEO, announces his retirement.
November 2000	S&P downgrade HIH credit rating to BBB^{+}. Some Asian operations are also sold. HIH also enters managing general agency agreement with Gerling Group.
December 15, 2000	HIH annual general meeting. Ray Williams steps down as director of HIH and Randolph Wein is appointed the new CEO. Shareholders call for resignation of Rodney Adler from HIH board.
February 22, 2001	ASX trading halt to HIH shares. Speculation that HIH will lose up to $500million.
February 26, 2001	HIH resumes trading. Rodney Adler resigns. ASIC raids HIH offices.
February 27, 2001	Trading halted at HIH's request. ASIC hands HIH documents to ASX. S&P lowers HIH Credit rating.
March 1, 2001	HIH shares suspended until interim profit released.
March 6, 2001	QBE forms joint venture with HIH in corporate insurance, takes 60% stake.
March 9, 2001	Allianz buys remainder of retail insurance venture for $125 million.
March 14, 2001	NRMA buys HIH workers' compensation business for $130 million.
March 15, 2001	HIH puts itself into provisional liquidation and estimates $800 million half year loss.
May 16, 2001	ASIC launches its biggest ever investigation, seizing HIH documents.
May 21, 2001	Federal Government announces a Royal Commission into what is at the time Australia's biggest corporate collapse.

Source: Australian Financial Review and HIH Royal Commission Website.

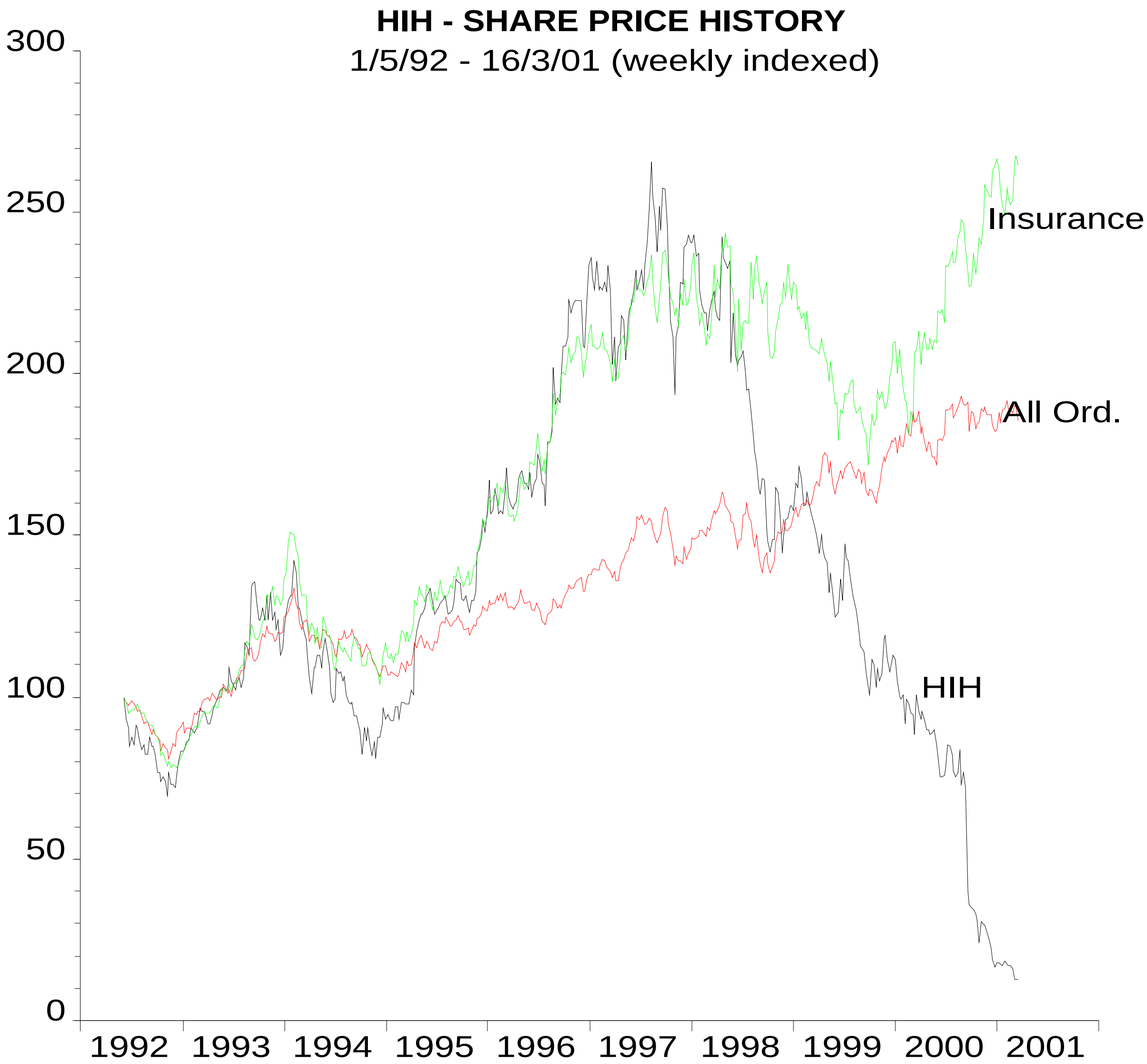

Figure 1

Source: DATASTREAM

Table 3
HIH Board Composition, Executive Compensation and Executive Shareholdings

1998/1999 Annual Report

Non-Executive Directors	Key Announcements	Compensation ($Aust)	Ordinary Shares	Options	Convertible Notes
G.A. Cohen (Chairman)		324,600	55,806		4,260
C. P. Abbott		204,386	59,647		
R.S. Adler	Appointed April 16, 1999	4,311,945	5,500,000		
J.H Gardner	Appointed December 2, 1998	31,377	46,894		
A. W. Gorrie		200,862			
N.R. Head		142,140			
E.W. Heri	Resigned effective October 15, 1998				
M.W. Payne	Retired as Executive June 30, 1998, appointed Non-Executive July 9, 1998	271,936	133,611	376,000	8,467
W.E. Schurpf	Resigned effective April 15, 1998				
R.H. Stitt		128,180	40,810		1,129
Executive Directors	**Key Announcements**	**Compensation ($Aust)**	**Ordinary Shares**	**Options**	**Convertible Notes**
R. Williams (CEO) and Deputy Chairman		1,460,350	10,336,383	500,000	19,200
T. Cassidy		916,777	6,941,213	400,000	10,000
D. Fodera		799,870	348,871	520,000	5,024
G. Sturesteps		986,294	6,242,061	320,000	9,700
H.R. Wein		517,687			

For the 1998/1999 annual report there were 12 directors on the board, three less than the maximum number provided for under the company's constitution.

1999/2000 Annual Report

Non-Executive Directors	Key Announcements	Compensation ($Aust)	Ordinary Shares	Options	Notes
G.A. Cohen (Chairman)		216,090	61,566		4,260
C. P. Abbott		86,400	209,832		
R.S. Adler		53,000	5,753,670		
J.H Gardner		57,000	112,713		
A. W. Gorrie	Resigned November 19, 1999	32,307			
N.R. Head	Resigned November 19, 1999	6,796			
M.W. Payne	Resigned effective September 12, 2000	133,317			
R.H. Stitt		63,514	140,260		1,129
Executive Directors	**Key Announcements**	**Compensation ($Aust)**	**Ordinary Shares**	**Options**	**Notes**
R. Williams (CEO)	Resigned effective December 15, 2000	1,147,692	12,222,715	500,000	19,200
T. Cassidy	Resigned effective October 12, 2000	671,900			
D. Fodera	Resigned effective October 12, 2000. Appointed Chief Operating Officer.	677,128			
G. Sturesteps	Resigned effective September 12, 2000	707,286			
H.R. Wein (new CEO)	Appointed new CEO December 15, 2000.	648,328	4,233		

For the 1999/2000 annual report, the Board of HIH had seven directors (5 Non-Executives and 2 Executives), eight less than the maximum number provided for under the company constitution.

On October 13, 2000 it was announced by HIH Chairman Geoffrey Cohen that Australian executives would no longer serve on the board. This meant that Terry Cassidy and Dominic Fodera would step down. Around this time Dominic Fodera was appointed Chief Operating Officer.

Source: Australian Financial Review and HIH Annual Reports. Data are in Australian dollars.

Table 4

Financial Highlights at HIH Insurance Group (1996 – 2000)

	12 months to June 1996	**12 months to June 1997**	**12 months to June 1998**	**12 months to June 1999**	**12 months to June 2000**
Premium (revenue earned–gross(excl. VWA)	1135.8	1343.0	1841.3	2318.4	2962
Premium revenue earned – net	888.5	1067.0	1300.5	1662.2	1995.4
Claims incurred and expenses	905.4	1094.5	1344.8	1808.4	2098.9
Combined ratio	101.9%	102.6%	103.4%	108.8%	105.2%
Underwriting Profit/Loss	(16.9)	(27.5)	(44.3)	(146.3)	(103.5)
Goodwill amortization	(4.7)	(5.2)	(7.3)	(17.2)	(35.3)
Interest expense	(1.8)	(4.8)	(4.7)	(17.9)	(31.5)
Investment return on shareholders' funds	26.1	95.8	31.4	71.1	60.4
Operating Profit after income tax, abnormal and extraordinary items	59.2	78.3	37.5	(39.8)	18.4
Dividend/share (cents)	13.0	15.0	16.0	12.0	6.0
Earnings/share (cents)	20.5	25.6	9.9	(0.4)	(0.6)
Net tangible asset backing per share – diluted *	1.23	1.38	1.66	1.02	0.67
Return on Equity	15.4%	16.3%	6.5%	-5.0%	2.0%

* Adjusted for full effect of Convertible and Converting Note Issues, where applicable

Other Financial Items

	31.12.97	**30.6.99**	**30.6.00**
Inflation Rate (%)	5.0	5.0	3.8
Discount Rate (%)	6.2	6.1	6.4
Outstanding Claims Details			
Expected Future claim payments (undiscounted)	$2,377.3	$4,4598.7	$4,922.9
Liability for Outstanding Claims (Aust$m)	$1,956.6	$4,051.5	$4,430.9

According to the HIH annual report, the weighted average expected term to settlement from the balance date of the outstanding claims is estimated to be 2.6-2.7 years. The inflation and discount rates displayed were used in measuring the consolidated outstanding claims liability for the succeeding and subsequent years.

Source: HIH annual report.

Adler was later convicted in a suit by the Australian Securities and Investment Commission (ASIC) for breaching his duty as a corporate officer in regards to a fraudulent $10 million loan made by HIH to Pacific Eagles Equity. The conviction carries a fine and a twenty year suspension from directorship of a company (Zenoni, 2002). Further questions emerged as to the solvency of FAI at the time of the acquisition as well as allegations of insider trading